

MEMORANDUM

TO: Delaware Public Service
Commission

FROM: Bluewater Wind, LLC

DATE: October 27, 2006

RE: Delmarva RFP Security Requirements

I. Introduction

We have reviewed the security requirements as proposed in the various drafts of Delmarva's RFP. As discussed in further detail below, the proposed security requirements are high compared to other renewable projects in the United States. We support the independent consultant's recommendation that intermittent projects be required to support only 40% of the proposed security requirements. There are additional mechanisms besides letters of credit that are available to mitigate developmental and operational risk. This memorandum discusses subordinated liens and other mechanisms in such context to provide the Public Service Commission (PSC) staff with alternatives to Delmarva's proposed development and operational security requirements.

We propose bid deposit security not to exceed \$3 per kW; an increased deposit through commercial operation of \$10 per kW; and a security deposit during operations of \$100 per kW. We further propose in lieu of cash or letter of credit security alternatives structures discussed below.

Delmarva in its draft RFP proposed development period security of \$50/kW at PPA execution and \$100/kW at the time the PSC approved the PPA, based on letters of credit in a form acceptable to Delmarva. Delmarva also proposed an operational security cap equal to the full replacement cost of the PPA with a letter of credit, the amount of credit extended by Delmarva being dependent on the bidder's credit rating. The independent consultant agreed with agreed with Delmarva's proposal, but recommended that such operational security be capped at \$200/kW, and that parent guarantees from investment grade companies be an acceptable form of security. Non-investment grade companies would need to post a letter of credit of \$200/kW under the independent proposal's recommendation. The independent consultant also recommended intermittent energy projects should only pay a 40% pro rata share based on their relatively low capacity factors and UCAP. In an informal "RFP issues list," PSC staff agreed with Delmarva's proposed security requirements, as well as the independent consultant's recommendations on the operational security limits, parent guarantees, and capacity reduction for intermittent projects. PSC staff also expressed tentative interest in a subordinated lien mechanism, with the senior lien being limited to 70% of the total capital cost of a given project.

II. Delmarva's Development and Operational Security Requirements

Credit policies imposed on new generation projects, particularly renewable projects, if not appropriately structured, could have a harmful impact on the success of a project. During the development stage, the developer typically does not have access to credit lines, and any security would typically be posted in the form of cash, placing a strain on the developer's development budget. Typically, security requirements that are set above-market will discourage bid participation and result in less competition in the solicitation process.

A. Amount of Security

The bid evaluation stage deposit proposed by Delmarva is too high relative to the deposit required by other utilities. We are aware that bid deposits required by other utilities are in the range of \$3 to \$5/kW, with some utilities not requiring a bid deposit. A lower bid deposit should result in more robust participation in the initial solicitation process, which will benefit ratepayers through increased competition.

The development stage deposit proposed by Delmarva is too high relative to the deposit required by other utilities. We are aware that bid deposits required by other utilities are in the range of \$10 to \$20/kW, and we are not aware of any development stage deposit above \$20/kW.

The security requirements proposed by Delmarva for the commercial operation stage are also too high given the reduced risk associated with an operating project. As discussed below, financial institutions involved in funding a project will be exercising close oversight over the project, and both equipment warranties and insurance will protect against any catastrophic failure.

B. Form of Security

Beyond the amounts required, the form of security is also problematic. Delmarva is requesting letter of credit support of its security requirements. Letters of credit are considered "liquid" security as they can be readily converted to cash. Typically, the developer pays a fee to the lender for the letter of credit, which typically range from 1 to 3 percent of the total amount of the letter of credit. These fees vary based on the perceived risk of the project, the credit quality of the developer, and other factors. For example if a project needed to obtain a \$200 million letter of credit, the project would typically have to pay \$2,000,000 to \$6,000,000 each year to a lender for the letter of credit.

The project impacts of obtaining development security, however, are larger than the out of pocket costs because such security requirements reduce the borrowing capacity of the project. First, smaller developers, such as Bluewater Wind, may be forced to place some amount of equity with the lender to secure the letter of credit, reducing the equity available for the project and increasing the returns necessary for the project. Secondly, the cost of a letter of credit reduces the cash available for financing, once again increasing the equity requirements for the project. Finally, a letter of credit reduces the overall borrowing capacity of the project.

The borrowing capacity of a project may be reduced by an amount equal to or less than the amount of the letter of credit, depending on the perceived risk of project default. Less borrowing capacity translates to an increased demand for equity, which requires higher returns. These

required higher returns could make the Bluewater's proposed project uneconomic, and Delaware's citizens could lose the environmental and fuel stability that Bluewater's project can bring.

III. Alternative Security Mechanisms

To fulfill its fiduciary responsibility to its shareholders, it is entirely appropriate that Delmarva protect itself from the risk that an IPP will fail to deliver by insisting on credit support. But in the interest of fairness, that credit requirement should be reasonably related to the actual risk of contract default.

Post commercial operation, while the developer should have access to credit lines, the cost of such security will likely be passed through to ratepayers in the form of higher purchased power costs. At this stage of the project, the risk to the utility of receiving the energy that it has contracted for has been significantly reduced. Typically, the financial institutions that have invested in the project will exercise oversight over the project to protect their investment. In addition, the developer will have in place equipment warranties and insurance to ensure the project's successful operation. Thus, the regulatory agencies should consider these risk mitigants in establishing a reasonable amount of security.

A number of states are currently evaluating the credit requirements for new power contracts. Rather than impose high security requirements, which are ultimately passed through to ratepayers, some states are encouraging the utilities to consider alternative security mechanisms such as:

- Subordinated security interests under which the utility accepts a lien on the project subordinated only to the senior lenders.
- Step-in rights, under which the utility is granted the right to step in and either complete the construction of a project or operate the project after a default by the developer.
- Requirements that insurance proceeds be either reinvested in the project or used as a buydown of the contract capacity.
- Assignments of a portion of the proceeds from a turbine warranty or availability guaranty, which are typically offered by most turbine manufacturers.

Such mechanisms are more reasonably to the risk of contract default. They will give Delmarva protection against failure of the project by actually allowing an equity interest in the project in the event of such failure. Thus Delmarva will have control over the output of the project, and will be ensured that it receives a reliable power supply and fulfills the mandate of the state legislature in terms of reliability and environmental benefits. These alternative mechanisms more equitably balance the risk and benefits to Delmarva and the project developers of new, innovative technologies in a way that protects the service to Delmarva's SOS customers and the health and economic stability of all Delaware's citizens.

IV. Conclusion

In sum, excessive credit requirements have costs that outweigh their benefits. Such credit requirements have three harmful effects on ratepayers: (1) they discourage otherwise-reliable IPPs from building cost-competitive generation; (2) they reduce wholesale competition and thereby raise retail prices; and (3), by forcing IPPs to purchase third-party credit support, such requirements unnecessarily increase the prices IPPs can offer utilities. These obstacles often disqualify projects employing off-shore wind or other advanced technologies from consideration for utility procurement. We support the independent consultant's recommendation that the security requirements be reduced to a percentage congruent with wind's capacity factor. We also respectfully request that the PSC staff consider alternative security mechanisms to ensure both Delmarva's supply requirements and the ability developers to successfully construct utility scale renewable energy projects.